

attributable to the ownership and operation of the building.

(b) *Limitation.* Notwithstanding paragraph (a) of this section, losses, deductions, or credits attributable to the ownership and operation of a qualified low-income building with respect to which the low-income housing credit under section 42 is allowable may be limited or disallowed under other provisions of the Code or principles of tax law. See, e.g., sections 38(c), 163(d), 465, 469; *Knetsch v. United States*, 364 U.S. 361 (1960), 1961-1 C.B. 34 ("sham" or "economic substance" analysis); and *Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978), 1978-1 C.B. 46 ("ownership" analysis).

(c) *Effective date.* The rules set forth in paragraphs (a) and (b) of this section are effective with respect to buildings placed in service after December 31, 1986.

[T.D. 8420, 57 FR 24729, June 11, 1992]

§ 1.42-5 Monitoring compliance with low-income housing credit requirements.

(a) *Compliance monitoring requirement—(1) In general.* Under section 42(m)(1)(B)(iii), an allocation plan is not qualified unless it contains a procedure that the State or local housing credit agency ("Agency") (or an agent of, or other private contractor hired by, the Agency) will follow in monitoring for noncompliance with the provisions of section 42 and in notifying the Internal Revenue Service of any noncompliance of which the Agency becomes aware. These regulations only address compliance monitoring procedures required of Agencies. The regulations do not address forms and other records that may be required by the Service on examination or audit. For example, if a building is sold or otherwise transferred by the owner, the transferee should obtain from the transferor information related to the first year of the credit period so that the transferee can substantiate credits claimed.

(2) *Requirements for a monitoring procedure—(i) In general.* A procedure for monitoring for noncompliance under section 42(m)(1)(B)(iii) must include—

(A) The recordkeeping and record retention provisions of paragraph (b) of this section;

(B) The certification and review provisions of paragraph (c) of this section;

(C) The inspection provision of paragraph (d) of this section; and

(D) The notification-of-noncompliance provisions of paragraph (e) of this section.

(ii) *Order and form.* A monitoring procedure will meet the requirements of section 42 (m)(1)(B)(iii) if it contains the substance of these provisions. The particular order and form of the provisions in the allocation plan is not material. A monitoring procedure may contain additional provisions or requirements.

(b) *Recordkeeping and record retention provisions—(1) Recordkeeping provision.* Under the recordkeeping provision, the owner of a low-income housing project must be required to keep records for each qualified low-income building in the project that show for each year in the compliance period—

(i) The total number of residential rental units in the building (including the number of bedrooms and the size in square feet of each residential rental unit);

(ii) The percentage of residential rental units in the building that are low-income units;

(iii) The rent charged on each residential rental unit in the building (including any utility allowances);

(iv) The number of occupants in each low-income unit, but only if rent is determined by the number of occupants in each unit under section 42(g)(2) (as in effect before the amendments made by the Revenue Reconciliation Act of 1989);

(v) The low-income unit vacancies in the building and information that shows when, and to whom, the next available units were rented;

(vi) The annual income certification of each low-income tenant per unit. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(vii) Documentation to support each low-income tenant's income certification (for example, a copy of the tenant's federal income tax return, Forms

W-2, or verifications of income from third parties such as employers or state agencies paying unemployment compensation). For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building). Tenant income is calculated in a manner consistent with the determination of annual income under section 8 of the United States Housing Act of 1937 ("Section 8"), not in accordance with the determination of gross income for federal income tax liability. In the case of a tenant receiving housing assistance payments under Section 8, the documentation requirement of this paragraph (b)(1)(vii) is satisfied if the public housing authority provides a statement to the building owner declaring that the tenant's income does not exceed the applicable income limit under section 42 (g);

(viii) The eligible basis and qualified basis of the building at the end of the first year of the credit period; and

(ix) The character and use of the non-residential portion of the building included in the building's eligible basis under section 42 (d) (e.g., tenant facilities that are available on a comparable basis to all tenants and for which no separate fee is charged for use of the facilities, or facilities reasonably required by the project).

(2) *Record retention provision.* Under the record retention provision, the owner of a low-income housing project must be required to retain the records described in paragraph (b)(1) of this section for at least 6 years after the due date (with extensions) for filing the federal income tax return for that year. The records for the first year of the credit period, however, must be retained for at least 6 years beyond the due date (with extensions) for filing the federal income tax return for the last year of the compliance period of the building.

(c) *Certification and review provisions—*

(1) *Certification.* Under the certification provision, the owner of a low-income housing project must be required to certify at least annually to the Agency that, for the preceding 12-month period—

(i) The project met the requirements of:

(A) The 20-50 test under section 42 (g)(1)(A), the 40-60 test under section 42 (g)(1)(B), or the 25-60 test under sections 42 (g)(4) and 142 (d)(6) for New York City, whichever minimum set-aside test was applicable to the project; and

(B) If applicable to the project, the 15-40 test under sections 42(g)(4) and 142 (d)(4)(B) for "deep rent skewed" projects;

(ii) There was no change in the applicable fraction (as defined in section 42(c)(1)(B)) of any building in the project, or that there was a change, and a description of the change;

(iii) The owner has received an annual income certification from each low-income tenant, and documentation to support that certification; or, in the case of a tenant receiving Section 8 housing assistance payments, the statement from a public housing authority described in paragraph (b)(1)(vii) of this section. For an exception to this requirement, see section 42(g)(8)(B) (which provides a special rule for a 100 percent low-income building);

(iv) Each low-income unit in the project was rent-restricted under section 42(g)(2);

(v) All units in the project were for use by the general public and used on a nontransient basis (except for transitional housing for the homeless provided under section 42 (i)(3)(B)(iii));

(vi) Each building in the project was suitable for occupancy, taking into account local health, safety, and building codes;

(vii) There was no change in the eligible basis (as defined in section 42(d)) of any building in the project, or if there was a change, the nature of the change (e.g., a common area has become commercial space, or a fee is now charged for a tenant facility formerly provided without charge);

(viii) All tenant facilities included in the eligible basis under section 42(d) of any building in the project, such as swimming pools, other recreational facilities, and parking areas, were provided on a comparable basis without charge to all tenants in the building;

(ix) If a low-income unit in the project became vacant during the year, that reasonable attempts were or are

being made to rent that unit or the next available unit of comparable or smaller size to tenants having a qualifying income before any units in the project were or will be rented to tenants not having a qualifying income;

(x) If the income of tenants of a low-income unit in the project increased above the limit allowed in section 42(g)(2)(D)(ii), the next available unit of comparable or smaller size in the project was or will be rented to tenants having a qualifying income; and

(xi) An extended low-income housing commitment as described in section 42(h)(6) was in effect (for buildings subject to section 7108(c)(1) of the Revenue Reconciliation Act of 1989).

(2) *Review.* The review provision must—

(i) Require that the Agency review the certifications submitted under paragraph (c)(1) of this section for compliance with the requirements of section 42;

(ii) Contain at least one of the following requirements:

(A) The owners of at least 50 percent of all low-income housing projects in the Agency's jurisdiction must submit to the Agency for compliance review a copy of the annual income certification, the documentation the owner has received to support that certification, and the rent record for each low-income tenant in at least 20 percent of the low-income units in their projects;

(B) The Agency must inspect at least 20 percent of low-income housing projects each year and must inspect the low-income certification, the documentation the owner has received to support that certification, and the rent record for each low-income tenant in at least 20 percent of the low-income units in those projects; or

(C) The owners of all low-income housing projects must submit to the Agency each year information on tenant income and rent for each low-income unit, in the form and manner designated by the Agency, and the owners of at least 20 percent of the projects must submit to the Agency for compliance review a copy of the annual income certification, the documentation the owner has received to support that certification, and the rent record for

each low-income tenant in at least 20 percent of the low-income units in their projects; and

(iii) Require that the Agency determine which tenants' records are to be inspected or submitted by the owners for review. If a monitoring procedure includes the review provision described in paragraph (c)(2)(ii)(B) of this section, the records to be inspected must be chosen in a manner that will not give owners of low-income housing projects advance notice that their records for a particular year will or will not be inspected. However, an Agency may give an owner reasonable notice that an inspection will occur so that the owner may assemble records (for example, 30 days notice of inspection). See paragraph (d) of this section for the inspection provision that is required to be included in all monitoring procedures.

(3) *Frequency and form of certification.* A monitoring procedure must require that the certifications and reviews of paragraph (c)(1) and (2) of this section be made at least annually covering each year of the 15-year compliance period under section 42(i)(1). The certifications must be made under penalty of perjury. A monitoring procedure may require certifications and reviews more frequently than on a 12-month basis, provided that all months within each 12-month period are subject to certification.

(4) *Exception for certain buildings—(i) In general.* The review requirements under paragraph (c)(2)(ii) (A), (B), and (C) of this section may provide that owners are not required to submit, and the Agency is not required to review, the tenant income certifications, supporting documentation, and rent records for buildings financed by the Farmers Home Administration (FmHA) under the section 515 program, or buildings of which 50 percent or more of the aggregate basis (taking into account the building and the land) is financed with the proceeds of obligations the interest on which is exempt from tax under section 103 (tax-exempt bonds). In order for a monitoring procedure to except these buildings, the Agency must meet the requirements of paragraph (c)(4)(ii) of this section.

(ii) *Agreement and review.* The Agency must enter into an agreement with the FmHA or tax-exempt bond issuer. Under the agreement, the FmHA or tax-exempt bond issuer must agree to provide information concerning the income and rent of the tenants in the building to the Agency. The Agency may assume the accuracy of the information provided by FmHA or the tax-exempt bond issuer without verification. The Agency must review the information and determine that the income limitation and rent restriction of section 42 (g)(1) and (2) are met. However, if the information provided by the FmHA or tax-exempt bond issuer is not sufficient for the Agency to make this determination, the Agency must request the necessary additional income or rent information from the owner of the buildings. For example, because FmHA determines tenant eligibility based on its definition of “adjusted annual income,” rather than “annual income” as defined under Section 8, the Agency may have to calculate the tenant’s income for section 42 purposes and may need to request additional income information from the owner.

(iii) *Example.* The exception permitted under paragraph (c)(4)(i) and (ii) of this section is illustrated by the following example.

Example. An Agency chooses the review requirement of paragraph (c)(2)(ii)(A) of this section and some of the buildings selected for review are buildings financed by the FmHA. The Agency has entered into an agreement described in paragraph (c)(4)(ii) of this section with the FmHA with respect to those buildings. In reviewing the FmHA-financed buildings, the Agency obtains the tenant income and rent information from the FmHA for 20 percent of the low-income units in each of those buildings. The Agency calculates the tenant income and rent to determine whether the tenants meet the income and rent limitation of section 42 (g)(1) and (2). In order to make this determination, the Agency may need to request additional income or rent information from the owners of the FmHA buildings if the information provided by the FmHA is not sufficient.

(d) *Inspection provision.* Under the inspection provision, the Agency must have the right to perform an on-site inspection of any low-income housing project at least through the end of the compliance period of the buildings in

the project. The inspection provision of this paragraph (d) is separate from any review of low-income certifications, supporting documents, and rent records under paragraph (c)(2)(ii) of this section.

(e) *Notification-of-noncompliance provision—(1) In general.* Under the notification-of-noncompliance provisions, the Agency must be required to give the notice described in paragraph (e)(2) of this section to the owner of a low-income housing project and the notice described in paragraph (e)(3) of this section to the Service.

(2) *Notice to owner.* The Agency must be required to provide prompt written notice to the owner of a low-income housing project if the Agency does not receive the certification described in paragraph (c)(1) of this section, or does not receive or is not permitted to inspect the tenant income certifications, supporting documentation, and rent records described in paragraph (c)(2)(ii)(A), (B), or (C) of this section (whichever is applicable), or discovers by inspection, review, or in some other manner, that the project is not in compliance with the provisions of section 42.

(3) *Notice to Internal Revenue Service—(i) In general.* The Agency must be required to file Form 8823, “Low-Income Housing Credit Agencies Report of Noncompliance,” with the Service no later than 45 days after the end of the correction period (as described in paragraph (e)(4) of this section, including extensions permitted under that paragraph) and no earlier than the end of the correction period, whether or not the noncompliance or failure to certify is corrected. The Agency must explain on Form 8823 the nature of the noncompliance or failure to certify and indicate whether the owner has corrected the noncompliance or failure to certify. Any change in either the applicable fraction or eligible basis under paragraph (c)(1)(ii) and (vii) of this section, respectively, that results in a decrease in the qualified basis of the project under section 42 (c)(1)(A) is noncompliance that must be reported to the Service under this paragraph (e)(3). If an Agency reports on Form 8823 that a building is entirely out of

compliance and will not be in compliance at any time in the future, the Agency need not file Form 8823 in subsequent years to report that building's noncompliance.

(ii) *Agency retention of records.* An Agency must retain records of noncompliance or failure to certify for 6 years beyond the Agency's filing of the respective Form 8823. In all other cases, the Agency must retain the certifications and records described in paragraph (c) of this section for 3 years from the end of the calendar year the Agency receives the certifications and records.

(4) *Correction period.* The correction period shall be that period specified in the monitoring procedure during which an owner must supply any missing certifications and bring the project into compliance with the provisions of section 42. The correction period is not to exceed 90 days from the date of the notice to the owner described in paragraph (e)(2) of this section. An Agency may extend the correction period for up to 6 months, but only if the Agency determines there is good cause for granting the extension.

(f) *Delegation of Authority*—(1) *Agencies permitted to delegate compliance monitoring functions*—(i) *In general.* An Agency may retain an agent or other private contractor ("Authorized Delegate") to perform compliance monitoring. The Authorized Delegate must be unrelated to the owner of any building that the Authorized Delegate monitors. The Authorized Delegate may be delegated all of the functions of the Agency, except for the responsibility of notifying the Service under paragraph (e)(3) of this section. For example, the Authorized Delegate may be delegated the responsibility of reviewing tenant certifications and documentation under paragraph (c) (1) and (2) of this section, the right to inspect buildings and records as described in paragraph (d) of this section, and the responsibility of notifying building owners of lack of certification or noncompliance under paragraph (e)(2) of this section. The Authorized Delegate must notify the Agency of any noncompliance or failure to certify.

(ii) *Limitations.* An Agency that delegates compliance monitoring to an Au-

thorized Delegate under paragraph (f)(1)(i) of this section must use reasonable diligence to ensure that the Authorized Delegate properly performs the delegated monitoring functions. Delegation by an Agency of compliance monitoring functions to an Authorized Delegate does not relieve the Agency of its obligation to notify the Service of any noncompliance of which the Agency becomes aware.

(2) *Agencies permitted to delegate compliance monitoring functions to another Agency.* An Agency may delegate all or some of its compliance monitoring responsibilities for a building to another Agency within the State. This delegation may include the responsibility of notifying the Service under paragraph (e)(3) of this section.

(g) *Liability.* Compliance with the requirements of section 42 is the responsibility of the owner of the building for which the credit is allowable. The Agency's obligation to monitor for compliance with the requirements of section 42 does not make the Agency liable for an owner's noncompliance.

(h) *Effective date.* Allocation plans must comply with these regulations by June 30, 1993. The requirement of section 42 (m)(1)(B)(iii) that allocation plans contain a procedure for monitoring for noncompliance becomes effective on January 1, 1992, and applies to buildings for which a low-income housing credit is, or has been, allowable at any time. Thus, allocation plans must comply with section 42(m)(1)(B)(iii) prior to June 30, 1993, the effective date of these regulations. An allocation plan that complies with these regulations, with the notice of proposed rulemaking published in the FEDERAL REGISTER on December 27, 1991, or with a reasonable interpretation of section 42(m)(1)(B)(iii) will satisfy the requirements of section 42(m)(1)(B)(iii) for periods before June 30, 1993. Section 42(m)(1)(B)(iii) and these regulations do not require monitoring for whether a building or project is in compliance with the requirements of section 42 prior to January 1, 1992. However, if an Agency becomes aware of noncompliance that occurred prior to January 1,

1992, the Agency is required to notify the Service of that noncompliance.

[T.D.8430, 57 FR 40121, Sept. 2, 1992; 57 FR 57280, Dec. 3, 1992; 58 FR 7748, Feb. 9, 1993; T.D. 8563, 59 FR 50163, Oct. 3, 1994]

§ 1.42-6 Buildings qualifying for carryover allocations.

(a) *Carryover allocations.* A carryover allocation is an allocation that meets the requirements of section 42(h)(1) (E) or (F). If the requirements of section 42(h)(1) (E) or (F) that are required to be satisfied by the close of the calendar year are not satisfied, the allocation is treated as if it had not been made. For example, if the taxpayer's basis in the project as of the close of the calendar year of allocation is not more than 10 percent of the taxpayer's reasonably expected basis in the project as of the close of the second calendar year following the year of allocation, the carryover allocation is not valid and is treated as if it had not been made.

(b) *Carryover-allocation basis*—(1) *In general.* Subject to the limitations of paragraph (b)(2) of this section, a taxpayer's basis in a project for purposes of section 42(h)(1) (E)(ii) or (F) (carryover-allocation basis) is the taxpayer's adjusted basis in land or depreciable property that is reasonably expected to be part of the project, whether or not these amounts are includible in eligible basis under section 42(d). Thus, for example, if the project is to include property that is not residential rental property, such as commercial space, the basis attributable to the commercial space, although not includible in eligible basis, is includible in carryover-allocation basis. The adjusted basis of land and depreciable property is determined under sections 1012 and 1016, and generally includes the direct and indirect costs of acquiring, constructing, and rehabilitating the property. Costs otherwise includible in carryover-allocation basis are not excluded by reason of having been incurred prior to the calendar year in which the carryover allocation is made.

(2) *Limitations*—For purposes of determining carryover-allocation basis under paragraph (b)(1) of this section, the following limitations apply.

(i) *Taxpayer must have basis in land or depreciable property related to the project.*

A taxpayer has carryover-allocation basis to the extent that it has basis in land or depreciable property and the land or depreciable property is reasonably expected to be part of the project for which the carryover allocation is made. This basis includes all items that are properly capitalizable with respect to the land or depreciable property. For example, a nonrefundable downpayment for, or an amount paid to acquire an option to purchase, land or depreciable property may be included in carryover-allocation basis if properly capitalizable into the basis of land or depreciable property that is reasonably expected to be part of a project.

(ii) *High cost areas.* Any increase in eligible basis that may result under section 42(d)(5)(C) from a building's location in a qualified census tract or difficult development area is not taken into account in determining carryover-allocation basis or reasonably expected basis.

(iii) *Amounts not treated as paid or incurred.* An amount is not includible in carryover-allocation basis unless it is treated as paid or incurred under the method of accounting used by the taxpayer. For example, a cash method taxpayer cannot include construction costs in carryover-allocation basis unless the costs have been paid, and an accrual method taxpayer cannot include construction costs in carryover-allocation basis unless they have been properly accrued. See paragraph (b)(2)(iv) of this section for a special rule for fees.

(iv) *Fees.* A fee is includible in carryover-allocation basis only to the extent the requirements of paragraph (b)(2)(iii) of this section are met and—

(A) The fee is reasonable;

(B) The taxpayer is legally obligated to pay the fee;

(C) The fee is capitalizable as part of the taxpayer's basis in land or depreciable property that is reasonably expected to be part of the project;

(D) The fee is not paid (or to be paid) by the taxpayer to itself; and

(E) If the fee is paid (or to be paid) by the taxpayer to a related person, and the taxpayer uses the cash method of accounting, the taxpayer could properly accrue the fee under the accrual